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Supreme Court of the United States.

OCTOBER TERM, 1931.

UNITED STATES CARTRIDGE COMPANY, PETITIONER.
v.
THE UNITED STATES.
No. 348.

REPLY BRIEF FOR THE PETITIONER.

I.

Reply to the argument for the respondent relating to deduction for cost of buildings erected on leased land.

A. The respondent's brief contains an argument which is made for the first time in this Court. No similar contention has ever been made in the case before. The respondent argues that the provisions of § 234 (a) (8) relating to amortization show that Congress did not intend to allow a deduction for obsolescence to a taxpayer whose buildings were erected for war purposes before the United States entered the war; and that this is shown both by the language of subsection (8) and by its legislative history.

It is submitted that, for the reasons stated below, this contention cannot be supported.

Sections 234(a) (4), (7) and (8) of the Revenue Act of 1918 provide for deductions from gross income of corporations including the following:

"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war the Commissioner may, and at the request of the taxpayer shall, reëxamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined, and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;"

The legislative history of the provisions relating to deductions for depreciation, exhaustion, wear and tear, and obsolescence is stated in the opinion in *V. Loewers Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, at p. 643. The only provisions on the subject in the Revenue Act of 1916 are found in section 12(a). The material portion of this section is as follows:

"Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade;" (Revenue Act of 1916, § 12(a), 39 Stat. 767.)

Under these provisions a deduction was allowed for loss of useful value which became complete during a given tax year. In other words, obsolescence was deductible when it reached the point of obsoleteness, but not before.

The attitude of the Bureau of Internal Revenue is shown by the following quotation from the letter of Commissioner W. H. Osborn to the Corporation Trust Company, dated September 19, 1916, and printed at page 254 in the 1918 Income Tax Service of the Corporation Trust Company.

"It is not possible in advance to determine when a piece of machinery, equipment or even a building will become obsolete. In other words, obsolescence cannot be anticipated and an annual deduction to take care of possible obsolescence cannot be allowed.

"The rules of this office contemplate that annual deductions for depreciation may be made to provide for loss due to wear and tear, the amount of such deduction to be determined upon the basis of the probable life of the property. If it shall occur that the property becomes obsolete or worthless before its estimated probable life shall have expired, a deduction representing the difference between the cost of the property and the amount previously charged off on account of depreciation may be deducted as a loss, this amount being a deduction due to the obsolescence of the property."

Abandonment of the use of the property was made by the Commissioner a condition precedent to the allowance for loss

of useful value. Whether he had the right to impose this condition need not be discussed, as the changes contained in the 1918 act make this question immaterial.

The second type of loss of useful value is that found in the brewery cases. In those cases it had become apparent in the year 1918 that after a certain time in a later year the plants could not be used for their original purposes. In such a case no loss for 1918 could have been deducted under the language in the Revenue Act of 1916 as a loss "sustained and charged off within the year," for the reason that the loss had not yet occurred in 1918. Congress, in enacting the Revenue Act of 1918 which imposed taxes running up to 82.4% of the net income, recognized the justice of permitting such a deduction, and did so in section 234(a) (7), which made an allowance for obsolescence in process, whether or not it ripened into obsoleteness within the year.

V. Loewers Gambrinus Brewery Co. v. *Anderson*, 282 U. S. 638.
Burnet v. *Niagara Falls Brewing Co.*, 282 U. S. 648.

There still remained a third type of case which was not within either section 234(a) (4) or section 234(a) (7). Various corporations had spent enormous sums after the United States entered into the war for facilities constructed for the production of articles contributing to the prosecution of the war. In many cases it was impossible to predict when their usefulness would end. Shipping, for instance, was in great demand after the Armistice, not only to bring home the army and its property, but also to replace the large tonnage which had been lost. The Shipping Board and the Emergency Fleet Corporation were active for a long time. Airplane construction was also continued until long after the Armistice, as the army had an insufficient supply of planes. At the end of 1918 no one could tell even approximately when these and certain other activities would stop. Consequently there was no adequate basis

on which to compute obsolescence for the year 1918 on such facilities. Owners faced ruin, however, if they were to be taxed on their 1918 income, computed without any allowance for obsolescence, at rates running up to 82.4% and the profits from subsequent years should prove insufficient to pay for the cost of the facilities. To cover such cases Congress by subsection 234(a) (8) provided for an additional allowance called "amortization," limiting it, however, to facilities acquired on or after April 6, 1917. Subsection 234(a) (8) departed from the general plan of the Revenue Acts, which took into account only events happening within the tax year, and provided for the deduction of estimated amounts based on loss of useful value expected to take place in the future, making an additional provision for a revision of the estimates at any time within three years after the termination of the war (meaning the official termination, which eventually took place on March 3, 1921). The subsection was reënacted in substance in the Revenue Act of 1921 as section 234(a) (8), but was omitted in the later Revenue acts. Under this subsection, either the Commissioner or the taxpayer could have a redetermination of the amount of the "amortization" before March 3, 1924, in the light of events as they had then turned out.

The meaning of the word "amortization" is one which has undergone a very recent change. The third revision of Bouvier's Law Dictionary, published in 1914, defines the term as follows:

> "Amortization. An alienation of lands or tenements in mortmain.
>
> It is used colloquially in reference to paying off a mortgage or other debt by instalments, or by a sinking fund."

Webster's New International Dictionary, published in 1925, contains the further definition

> "Amortize. 3. To clear off, liquidate, or otherwise extinguish, as a debt, usually by a sinking fund. Hence:

a. To extinguish (a premium or a discount involved in the purchase of a security) by periodically charging off a portion (of the premium) or crediting a portion (of the discount) so as to bring the value to par at maturity, the transfer being made respectively from income to investment or vice versa. b. Loosely, to bring the value of (a security) to par in this way."

Accountants customarily use this word to include any method by which a reserve is set up from income to provide against an anticipated loss of value of particular assets. It is undoubtedly used in this sense in section 234(a).

There is no good ground for the argument that because this extraordinary kind of deduction for anticipated loss of value was limited by subsection 234(a) (8) to cases of facilities acquired on or after April 6, 1917, the other deductions contained in subsections (4) and (7) must be held to be so limited. If the argument for the respondent that subsection (8) by implication denies any deduction for obsolescence in the case at bar were sound, it would follow logically that it would deny also any deduction for exhaustion or wear and tear, all of which are specified in subsection (7) along with obsolescence. The Commissioner, however, admits that subsection (8) does not have that effect; for he has made an allowance of $86,484.50 to the petitioner for ordinary exhaustion of the leasehold for 1918.

As was said in the opinion in *V. Loewers Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, in dealing with the claim of another alleged limitation of subsection (7) by implication, "The language of section 234(a) (7) is broad enough to include all obsolescence from whatever cause . . . The cost of plant depreciation, *i.e.*, exhaustion, wear, tear and obsolescence, is a part of operating expenses necessary to carry on a manufacturing business. The gain or loss in any year cannot be rightly ascertained without taking into account the amount of such

cost that is justly attributable to that period of time." (Opinion, pp. 641–643.)

It is reasonable to suppose that Congress in an act which imposed taxes at the high rates contained in the Revenue Act of 1918, intended that income should be "rightly ascertained." Certainly no contrary intention should be imputed by implication.

If Congress had intended to take away from persons who owned war facilities acquired before April 6, 1917, all right to any allowance for obsolescence arising from the ending of the war, the natural way to have done it would have been by a proviso at the end of subsection (7) and not by relying upon an implication to be drawn from subsection (8), which dealt with a deduction called "amortization."

The only reasonable conclusion is that subsection (8) was intended to give additional deductions, and was not intended to restrict those which were given in other subsections. A decision in which this view is clearly stated, and which also illustrates the practical application of the provisions of subsection (8) is *Elliott* v. *United States*, 16 F. 2d 164.

B. The argument is made in the respondent's brief that the termination of the war did not prevent the petitioner from using the buildings "for the purposes for which they were constructed" (p. 18).

In support of this argument it is said that the principal use of them after the war was for the manufacture of commercial ammunition; that they were well adapted for this purpose; and that there was nothing to show at the end of 1918 that this would not be a profitable use.

The answers to this argument are as follows:

In the first place, the buildings were not erected for the purpose of making commercial ammunition. The Company had no use for them except for war production. The petitioner in its war production employed 15,000 persons as against 350 to 400 employed in its commercial business before the war,

and required for its war business five times the space which it had previously used (Special Findings 43, 46, R. 77–79). After the Armistice the petitioner's position with respect to its commercial business was difficult as each of the five munition manufacturers in the country had a capacity much greater than in previous peace times, and each strove to get as much of the business as possible. Competition was severe and keen. The industry was believed to be declining and the only way to get new business was to take it away from competitors (Special Findings 50, 52, R. 81, 82). The buildings could not be rented after the war, as there was no demand for them (Special Finding 51, R. 81). It is clear that the petitioner in trying to get some return from the buildings by using them after 1918 was not using them "for the purpose for which they were constructed."

In the second place the value on December 31, 1918, of the right to use these buildings in the petitioner's peace time business for the remainder of the lease ($190,969.86) has been credited in making up the petitioner's claim. This credit takes into account any allowance which should fairly be made because the buildings were used for ordinary commercial purposes after 1918.

In the third place, the petitioner's claim is not based merely on the fact that it made no profits after 1918. The petitioner's claim for obsolescence was complete at the end of 1918 when it was known that its war business was over. It then had the right to charge off the difference between the depreciated cost of the buildings ($605,391.75) and their residual value ($190,969.86). The findings in this case as to lack of profits in later years are not so much a part of the petitioner's case as they are in the nature of a rebuttal of any possible claim of the respondent that the buildings might, in fact, have been worth more to the petitioner than their residual value. Accordingly, the argument made in the brief for the respondent that no one could tell at the end of 1918 whether the petitioner would

make profits in the future does not affect the issue. It is to be noted that this same argument, if valid, would have prevented any allowance for obsolescence in the cases of the brewery companies which continued to use their plants to make soft drinks.

C. It is argued in the brief for the respondent that the case at bar presents merely such a fluctuation in value *of property* as results from a falling off in demand due to a business depression, and that such fluctuations are not the basis of a deduction for absolescence. This argument overlooks the distinction between fluctuations in the volume of a business due to trade conditions, which are in their nature temporary, and changes which result in the discontinuance of demand for certain kinds of goods. There was no greater prospect in December, 1918, that the petitioner's buildings would ever be used again to make war ammunition than there was that brewery buildings would be used again to make beer after January, 1920. If absolescence is allowable in the latter case, it is equally allowable in the former.

D. It is argued in the respondent's brief that the petitioner's method, which takes a deduction in the year 1918 of approximately 50% of the cost of the buildings, is unfair (p. 21). The answer is that *the reduction in value which took place in 1918 amounted to about 50% of the cost of the buildings.* Can anyone who remembers the conditions which prevailed at the beginning of 1918 have any doubt that a complete and relatively new small arms ammunition plant actually engaged in production had a value on January 1, 1918, at least as great as its cost less depreciation, which is the value used in the case at bar? The fact that the drop from this value to the residual value of $190,969.86 all happened in 1918 is the best of reasons for allowing an equivalent deduction in that year.

II.

Reply to the argument for the respondent concerning the valuation of the petitioner's inventories.

The points made in the brief for the respondent are for the most part covered by the petitioner's original brief. A few of them will be noted below in order to clarify the issues raised.

A. The argument for the respondent is based throughout on the proposition that the contracts which the petitioner had in December, 1918, "secured the petitioner against loss" on its inventories (pp. 21–32).

In so far as this contention is based on a claim that the original contracts as they stood on December 31, 1918, gave the petitioner the right to deliver its inventories and to be paid for them in regular course of business because (it is claimed) the suspension notices were elections by the Chief of Ordnance to exercise the options contained in the cancellation clauses of the contracts, the answer is found in the petitioner's original brief at pages 28–35, in which it is shown that the petitioner was not "secured" in that sense. If, as was really the case, the petitioner had on December 31, 1918, no right to deliver these inventories and to be paid for them, but had then to depend only on future negotiations, or a suit in the Court of Claims for breach of contract, in order to secure reimbursement for the difference between their cost and their market value, the decision on which the respondent relies (*Mutual Chemical Company of America* v. *Commissioner*, 12 B.T.A. 578) has no application. That was clearly a case in which a contract was in course of performance in the ordinary way, and the language in the Board of Tax Appeals was intended to apply only to such a case. This appears in the extract from the opinion printed in the respondent's brief at page 23, in which reference is made to "the following year when the sales were executed."

If the respondent by the expression "secured against loss"

means to include such right as the petitioner had to treat the contracts as broken and to recover damages for the breach by suit in the Court of Claims, it is submitted that the existence of such rights would not sustain the proposition that the inventories must be valued at cost. Even if it be conceded for the sake of the argument that the petitioner had a valid cause of action against the United States, it does not follow that the amount which could be recovered at the end of the litigation should be treated as income of the year 1918.

Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359.
See authorities cited in the petitioner's brief, pp. 36–47.

The Commissioner has, however, by taking the inventories at cost, valued them at a figure which includes their market value plus any possible damages recoverable for breach of contract on account of these inventory items.

B. The argument is made in the brief for the respondent that subsequent events may be considered in determining the value of the inventories of December 31, 1918. It is contended that the settlement contracts made in the years 1920 to 1922, by which most of the materials were taken over and paid for at cost, were the best evidence of the value of the materials which was available to the Commissioner (p. 31). It is difficult to see the force of the argument. The issue in this case is whether the petitioner was entitled to value its inventories at market on December 31, 1918. The Court of Claims has specifically found that the market value of these inventories on that date was $231,615.43 (Special Finding 42, R. 77). That finding cannot be overturned by proof of what was obtained in the later settlements.

C. The brief for the respondent also refers to words used in the opinion of the Court of Claims to the effect that the petitioner had at the end of 1918 an enforcible demand for the cost of the goods in the form of a positive covenant to pay the same; and in this connection *McCreery* v. *Commissioner*,

4 B.T.A. 967 is cited (pp. 31–32). If the case at bar were one in which on December 31, 1918, the petitioner had contracted to sell these inventories and the United States had agreed to accept and to pay for them on terms specified in the contracts, and if all that remained to be done had been the accounting necessary to calculate the number of dollars payable (as was true in the *McCreery* case), the language in the Court of Claims and the decision in the *McCreery* case might have a bearing on the issue. The difficulty with the argument in the case at bar is, as has already been shown in the petitioner's brief, that no such situation existed on December 31, 1918 (Brief, pp. 28–35).

D. The brief for the respondent also suggests that the Commissioner made the regulations (p. 21); that his interpretation of the regulations is of great weight; that evidently he believed that the contracts were "firm sales contracts" because he valued the inventories at cost; and that his ruling should not be upset, even if inconsistent with the language of the regulations (p. 27). This argument overlooks several considerations. The first is that the Commissioner cannot make regulations by himself, but only with the approval of the Secretary of the Treasury (Revenue Act of 1918, section 203). The regulations, when so made and approved, are as binding on the Commissioner as on anyone else. It is further to be borne in mind that the Commissioner, in applying the regulations to individual cases, acts through large numbers of subordinates. As everyone knows, it is their interpretation of the regulations which is applied in any specific case, including the case at bar. If each subordinate has the right not to apply the regulations as they stand, and to depart from the language of them in order to carry out what he conceives to be their probable purpose, there is an end to all uniformity of administration. The argument for the respondent alleges that the regulations when promulgated "have the force of law and are as binding upon the courts as if incorporated in the statute

itself." (Brief, pp. 21–22.) It would be a most extraordinary situation if the courts were bound to follow the regulations as they stood, but the subordinates of the Commissioner might depart from them. It is submitted that the sound rule that statutes are to be construed according to the plain meaning of the words used applies equally to regulations.

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